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AGENDA ITEM 10a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Corporate Governance Investment Program Performance Review
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

Executive Summary

This agenda item addresses Investment Committee requests at its March 2008 Meeting on the performance of the Corporate Governance Investment Program (Investment Program.) Staff has prepared this information update of CalPERS' current \$5.1 billion globally diversified Investment Program with the objectives to:

- Produce a positive alpha through the generation of superior investment returns with CalPERS' existing corporate governance strategy external partners and co-investment opportunities.
- Increase the capital commitment to the Investment Program.
- Identify new external partners and co-investment opportunities to take advantage of innovative and sustainable investment strategies.

Attachment 1 provides a Wilshire opinion letter stating that staff has accurately described the Corporate Governance Program through this agenda item.

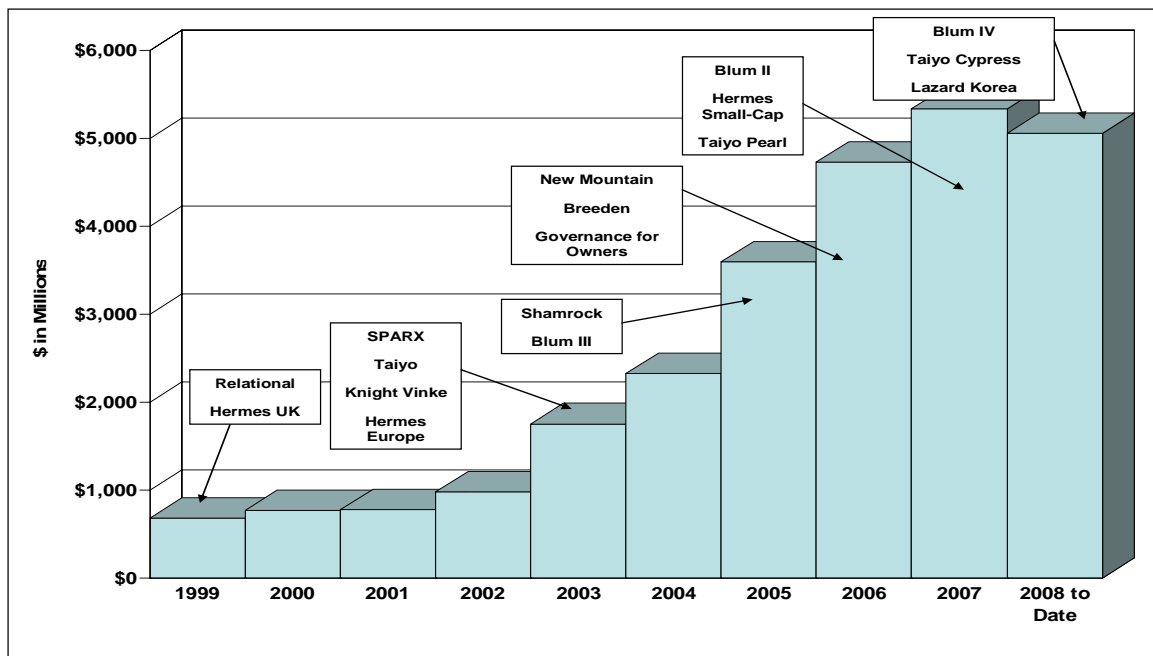
Corporate Governance Active Investment History

The Investment Program is one of four programs that create the framework of CalPERS' Corporate Governance Unit. The Investment Program began in 1999 with

a \$200 million investment with Relational Investors, LLC. Since then, the Investment Program has expanded to sixteen corporate governance funds and an internally managed co-investment program. As of June 30, 2008, the total asset value of the Investment Program was \$5.1 billion with \$4.4 billion invested with externally managed corporate governance funds and \$702 million in the internally managed co-investment portfolio.

The Investment Program is geographically diversified with exposure to US, European and Asian markets. Chart 1 shows the growth in the market value of assets for the Investment Program since inception.

Chart 1: Corporate Governance Asset Growth



At its February 2007 meeting, the Investment Committee gave staff the delegation to expand the scope of corporate governance investments to include emerging market corporate governance funds. The Investment Committee approved a total allocation to emerging market corporate governance funds of up to 10% of the total market value of the Investment Program, or approximately \$500 million. In April of 2008, the Investment Program made its first investment in emerging markets by committing \$100 million to the Lazard Korean Corporate Governance Fund. Staff is conducting due diligence on three additional emerging market funds.

Actions implemented over the last fiscal year include additional committed capital to those partners with proven and successful investment processes. These include two new funds managed by Taiyo Pacific Partners, a fund managed by Hermes, a fund managed by Blum Capital, and a fund managed by Relational Investors. In addition, there are seven new funds in various stages of the due diligence process.

Investment Performance

An analysis of the investment performance within the Corporate Governance Program requires the recognition of two elements that provide context.

- The Investment Program consists of two primary segments of activity; external discretionary partners, and internal co-investments made alongside the external partners.
- The various portfolios, external and internal, managed within the Investment Program tend to be very concentrated with few holdings, high active risk levels, and a very deep “value” style bias. Value investing is taking positions in securities that are perceived to be under-priced relative to the market. Securities that have underperformed the market and peers are typically judged to be “value” style securities.

Charts 2 through 4 show the returns of the total Investment Program as well as the two segments, external and internal, over various time periods. The long-term performance results are excellent as shown by Chart 2 where the 5-year and since inception numbers demonstrate positive value added of 1.68% and 5.82% respectively. Short-term results have been very challenging with the total Investment Program falling behind the benchmark by 7.06% for the last fiscal year.

The external partners segment (shown in Chart 3) makes up 86% of the asset weight and, as expected, has results that mirror the pattern shown for the total Investment Program. The co-investment segment (shown in Chart 4) has demonstrated positive value added performance results in all time periods as shown by the 1- and 5-year positive relative performance of 1.29% and 11.57% respectively.

Chart 2: Total Investment Program Returns as of 6/30/2008

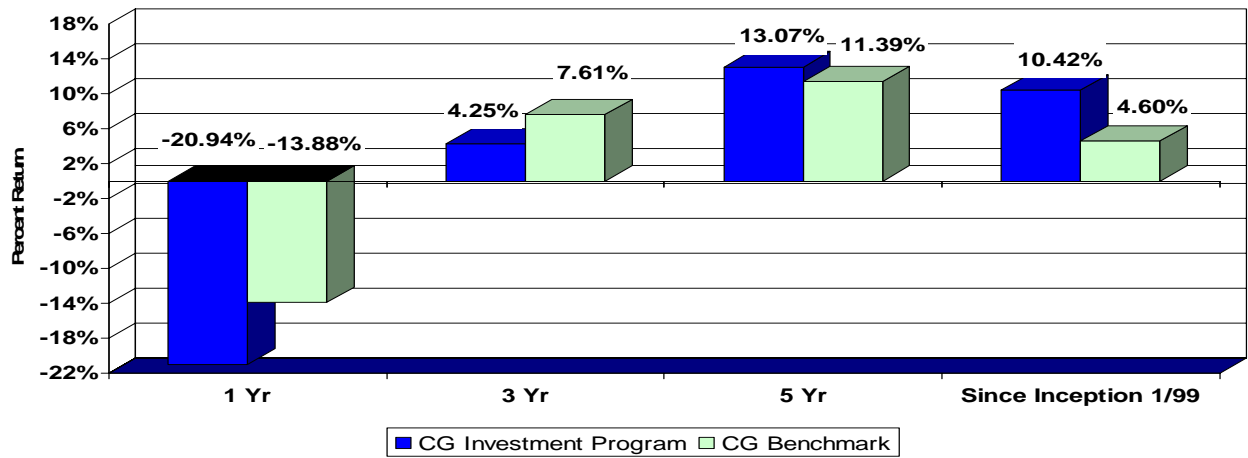


Chart 3: External Partners Segment Returns as of 6/30/08

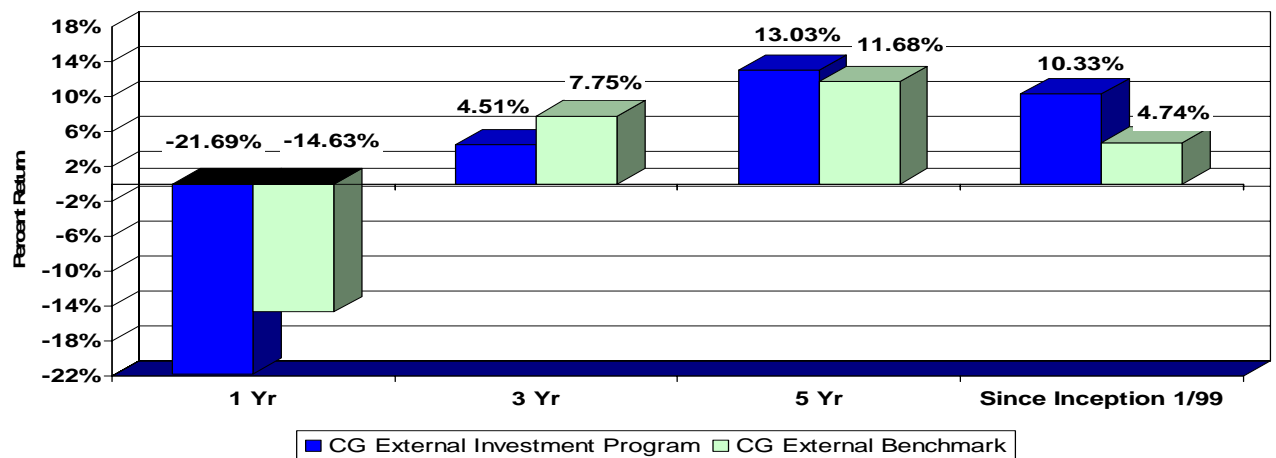
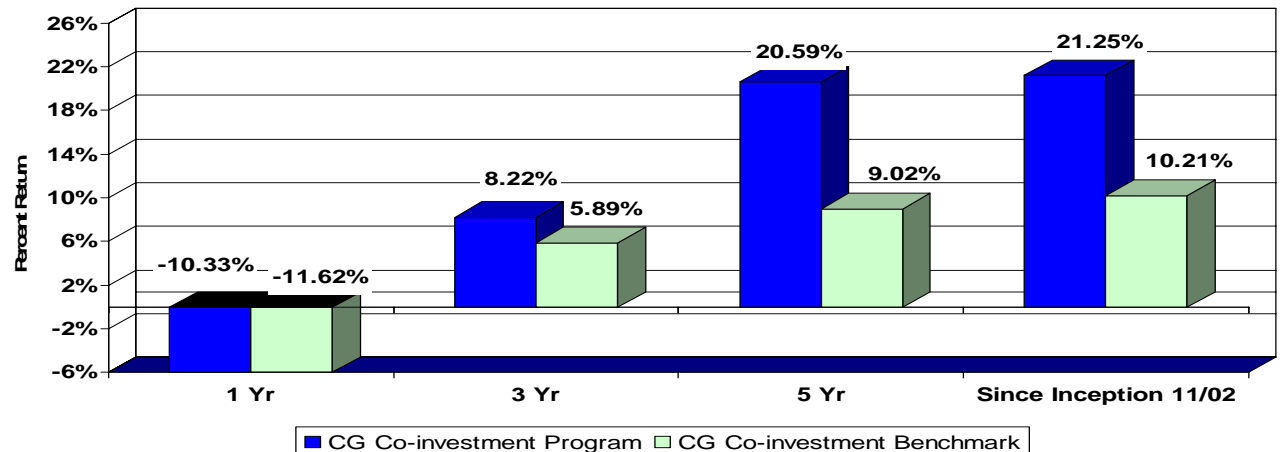


Chart 4: Co-Investment Segment Returns as of 6/30/08



State Street Bank methodology is CFA Institute compliant.
All figures are net of all fees for periods ending June 30, 2008.

The performance return results in Charts 2 through 4 need to be judged within the context of the previously mentioned portfolio holding concentration and “value” style bias comments. The Investment Program takes portfolio positions in companies that generated significant underperformance when compared to the general market and peers, commonly referred to as “value” investing. The portfolio positions taken are limited to those situations where the external partners believe an engagement process can effect positive investment returns.

The exposure of the Corporate Governance Investment Program portfolios to the “value” style of investing can cause severe swings in relative performance both positive and negative. In the fiscal year ending June 2008, domestic “value” investments (proxied by the S&P 500 Pure Value Index) underperformed the general market (S&P 500) by 19.5% (-34.3% versus -14.8%). Over the trailing 5 year period, domestic “value” investments outperformed the general market by 3.4% (+34.8% versus +31.4%). International markets (MSCI EAFE Index) have shown similar short term performance patterns with value investments being down 17% while the general market has declined by 13.5%.

Tables 1 and 2 below show information on Investment Program partner specific asset levels, risk, and investment performance. The “Active Risk” column of the tables shows the effect of the portfolio’s concentration and style risk. These expected tracking variance percentages range from a low of 6.2% to a high of 21.6% and represent the extremely idiosyncratic nature of the investments. CalPERS’ mainstream active external partners typically have expected tracking levels of 4% to 5% in comparison. Given the expected tracking and “value” style exposure of the Corporate Governance portfolios, the fiscal year 2008 performance is neither surprising nor difficult enough to drag down the much more favorable long term performance.

The portfolio of greatest concern is the Hermes Focus Asset Management portfolio. Hermes has been notified of staff concerns regarding the long-term underperformance of this portfolio. Staff is also in communication with all other external partners on a regular basis and concerns for underperformance are addressed as needed.

Table 1: Domestic Performance

FUND NAME	Ending Market Value	Active Risk %	1 Year	3 Years	5 Years	Since Inception
BLUM STRATEGIC PARTNERS II	17,951,594	6.2	-22.20			-22.20
8% OBJECTIVE			8.00			8.00
Excess			-30.20			-30.20
BLUM STRATEGIC PARTNERS III	133,941,511	15.0	-32.02			-3.24
8% OBJECTIVE			8.00			8.00
Excess			-40.02			-11.24
BLUM STRATEGIC PARTNERS IV	140,880,083	20.9				-34.17
8% OBJECTIVE						3.92
Excess						-38.09
BREEDEN PARTNERS	497,957,472	14.0	-8.96			4.55
S&P 500 INDEX			-13.12			2.36
Excess			4.16			2.19
NEW MOUNTAIN CAPITAL	217,497,000	8.5	-4.81			3.42
S&P 500 INDEX			-13.12			2.98
Excess			8.31			0.44
NEW MOUNTAIN CO-INVESTMENT	147,654,400	19.4	28.75			27.68
S&P 500 INDEX			-13.12			-2.41
Excess			41.87			30.09
RELATIONAL INVESTORS	706,077,122	15.5	-28.67	-3.06	8.94	13.98
CUSTOM S&P 500 - PERS EXT MGR			-13.10	4.42	7.59	2.12
Excess			-15.57	-7.48	1.35	11.86
RELATIONAL CO-INVESTMENT	229,462,193	22.1	-19.64	3.38	17.33	18.41
CALPERS CUSTOM INTERNAL RELATIONAL			-13.10	4.34	8.06	9.35
Excess			-6.54	-0.96	9.27	9.06
SHAMROCK GOVERNANCE FUND, LLC	117,947,229	15.5	-26.27	-2.70		-2.63
RUSSELL 2000			-16.19	3.79		4.24
Excess			-10.08	-6.49		-6.87

State Street methodology is CFA Institute compliant.
All figures are net of manager fees for periods ending June 30, 2008.
Inception dates for each manager are based on the initial draw down of capital.

Table 2: International and Emerging Markets Performance

FUND NAME	Ending Market Value	Active Risk %	1 Year	3 Years	5 Years	Since Inception
GOVERNANCE FOR OWNERS	261,224,682	11.2	-27.47			-6.91
FTSE ALL WORLD EUROPE			-9.57			3.37
Excess			-17.90			-10.28
GOV. FOR OWNERS CO-INVESTMENT	133,858,253	20.2				-28.48
FTSE ALL WORLD EUROPE						-7.89
Excess						-20.59
HERMES EUROPEAN FUND	242,866,682	12.6	-17.82	16.67		20.69
FTA EUROPE EX UK			-9.59	16.46		19.50
Excess			-8.23	0.21		1.19
HERMES FOCUS ASSET MGMT LTD	310,204,517	12.8	-30.79	2.80	10.11	4.96
FTSE ALL SHARE			-13.36	11.17	15.68	5.29
Excess			-17.43	-8.37	-5.57	-0.33
HERMES UK SMALL CAP	43,646,719	10.3				-26.51
FTSE Small Cap Ex Investment Trusts						-29.40
Excess						2.89
KNIGHT VINKE INSTITUTIONAL PARTNERS	233,317,916	8.2	-1.29	23.46		24.65
FTSE ALL WORLD EUROPE			-9.57	15.19		17.18
Excess			8.28	8.27		7.47
KNIGHT VINKE CO-INVESTMENT	191,806,885	14.1	7.23			26.99
FTSE ALL WORLD EUROPE			-9.57			10.01
Excess			16.80			16.98
SPARX VALUE CREATION FUND	204,871,784	21.6	-43.72	-10.65	5.39	8.43
TOPIX JPY			-25.62	3.89	8.28	9.87
Excess			-18.10	-14.54	-2.89	-1.44
TAIYO CYPRESS FUND	189,417,680	11.7				-8.27
TOPIX JPY						-2.84
Excess						-5.43
TAIYO FUND MGMT	725,623,123	12.1	-10.85	12.48		17.94
TOPIX JPY			-25.62	3.89		7.57
Excess			14.77	8.59		10.37
TAIYO PEARL FUND	190,249,906	12.5				-5.02
Absolute Return of 0%						0.00
Excess						-5.02
LAZARD KOREA CORP. GOV. FUND	98,575,285	16.7				-2.04
KOSPI						-11.24
Excess						9.20

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Inception dates for each manager are based on the initial draw down of capital.

The Investment Program portfolios need to be viewed from a long term perspective as evidenced by their active risk levels, style sensitivities, and protracted nature of the engagement process.

Charts 5 and 6 illustrate how the Corporate Governance Investment Program has consistently outperformed its benchmark over longer periods of time. Each point in Charts 5 and 6 represent total Investment Program performance versus the benchmark for a given performance period. The line going diagonally across the chart represents parity, where investment performance equals the benchmark. Points above the line indicate investment out performance relative to the benchmark and points below the line indicate investment under performance relative to the benchmark. On a one year rolling basis (Chart 5), 24 out of 35, or 69% of one year returns exceed the benchmark. On a five year rolling basis (Chart 6), 19 out of 19, or 100% of five year returns exceed the benchmark.

Chart 5: Corporate Governance Investment Program Rolling 1 Year Returns Since Inception
as of end of each quarter ending 06/30/08

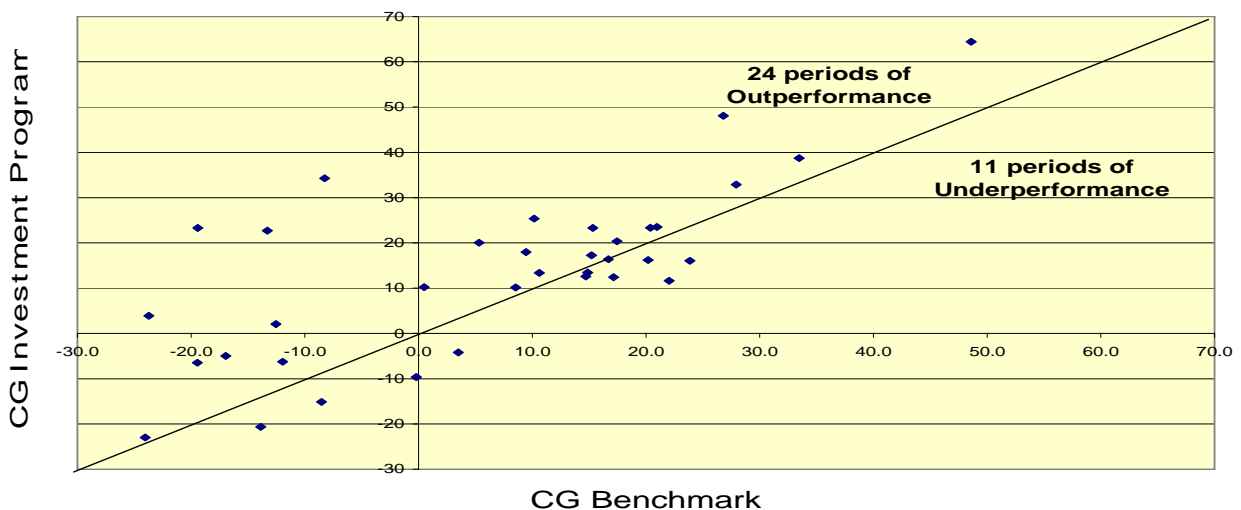
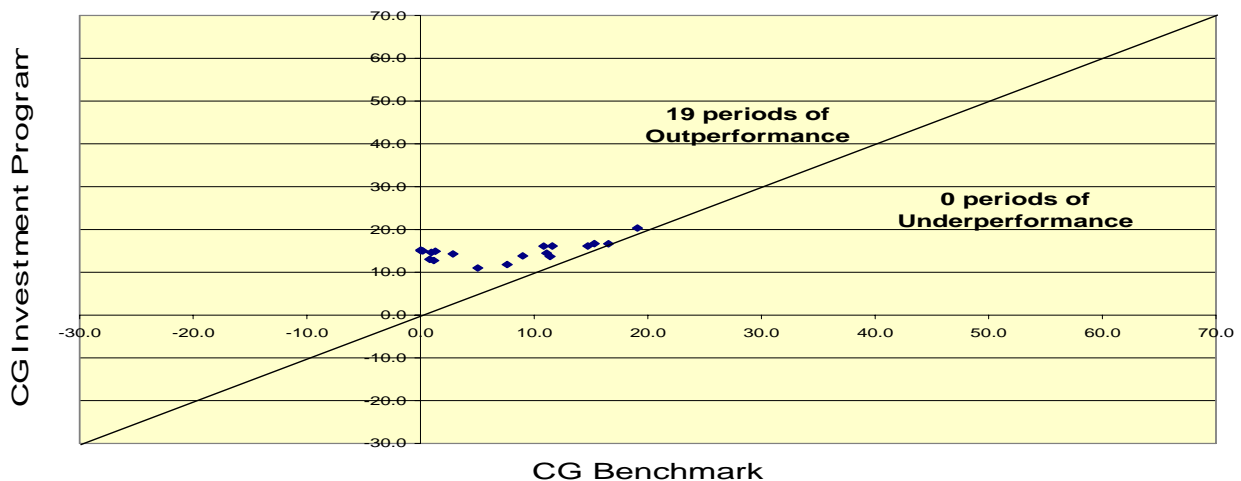


Chart 6: Corporate Governance Investment Program Rolling 5 Year Returns Since Inception
as of each quarter end through 06/30/08



Risk Management and Portfolio Construction

The CalPERS Risk Management Unit monitors and assesses risk at both the Investment Program and partner levels. The Risk Management unit is able to do this with security specific information provided by International Fund Services (IFS) for each corporate governance investment partner. At the Investment Program level, staff is able to look at the level of total risk, the source of risk, and each individual partner's contribution to the total risk for the Investment Program. The Risk Management unit also provides corporate governance staff the tools to look at the composition and source of risk for each external corporate governance investment partner.

Corporate Governance staff approach all incremental investment decisions from the perspective of each investment's impact on the overall structure of the Investment Program's portfolio. Using the IFS and Risk Management Unit data, staff is able to perform "what if" types of modeling to reflect the expected impact of changes to the portfolio. The objective is to use each investment decision to improve the overall Investment Program on the parameters of expected return and reduction of risk through increased partner diversification, geography, and security exposure.

Conclusion

Short term performance has been challenging; but, within the bounds established by the variability of these very idiosyncratic portfolios. Underperformance that stretches beyond three years elicits heightened communication between CalPERS' staff and the underperforming partner for the purpose of holding the partner accountable for corrective action. Partners showing persistent underperformance beyond five years without a suitable corrective plan face termination by CalPERS.

Going forward, staff will continue to execute on the Corporate Governance Investment Program's objectives to produce a positive alpha, increase capital commitments to superior performing partners, and identify new external partners and co-investment opportunities to take advantage of innovative and sustainable investment strategies.

V. STRATEGIC PLAN:

The item is consistent with the Strategic Plan: Goal I, Exercise global leadership to ensure the sustainability of CalPERS' pension and health benefit systems; and Goal IX, Achieve long-term, sustainable risk adjusted returns.

VI. RESULTS/COSTS:

The costs associated with this item are minimal as they are already absorbed by other ongoing CalPERS investment programs.

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